Annual review and outlook for 2020

Looking back on 2019 gives us, and certainly our clients, much more pleasure than looking back on 2018.

For long stretches of the year, stock and bond markets apparently knew only one direction: Upwards! Price increases for bonds (i.e. falling yields) and equities showed a positive synchronization for investors. At the end of the year, there is hardly any form of investment that would not have “delivered” a convincing return for 2019.

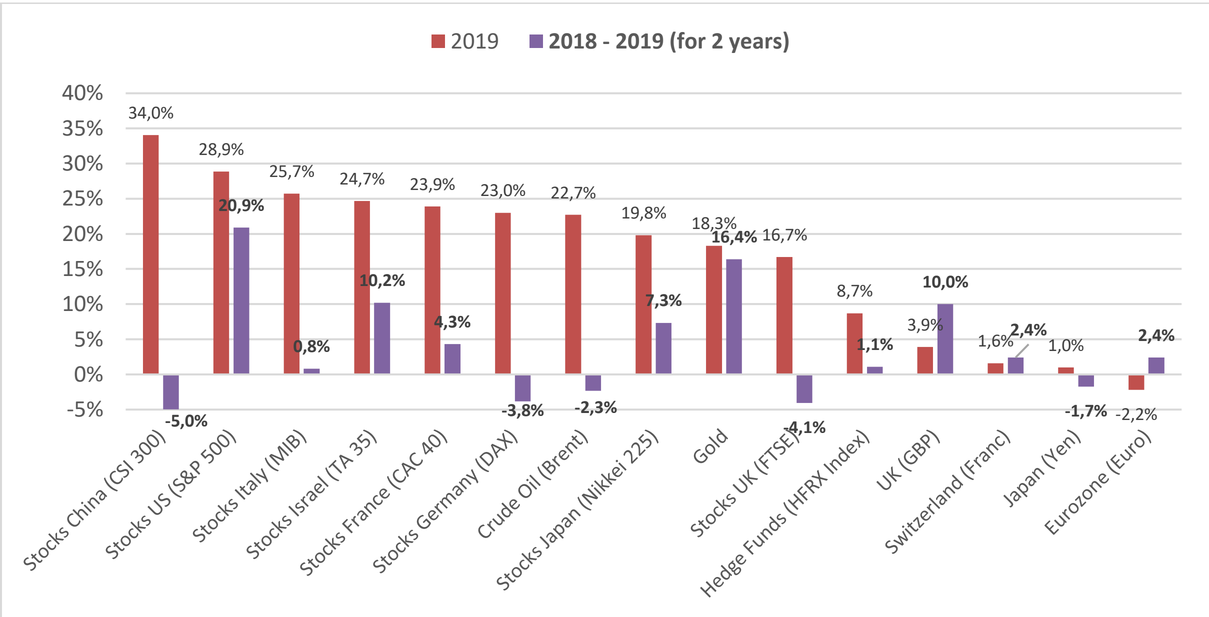
2019 - A thoroughly enjoyable year for investors

However, you cannot close your eyes to the fact that there was no lack of excitement and hectic market reactions in the financial markets last year.

If one extends the valuation of the results over time to 2018, many of the seemingly spectacular performances of the past year are put into perspective. Investments such as gold or US stocks were able to defend their strong results over the 2-year period. Other markets (e.g. “China stocks” with + 34 % for 2019, but – 5 % over two full years) clearly show that large fluctuations do not automatically lead to above-average performance.

The following graphic shows the development of selected investment markets in 2019 and for the 2-year period from 2018 to 2019:

Development of important investment markets 2018 to 2019 (overall performance of a US Dollar investor)



Data source: Bloomberg

The bond markets of the major currency areas benefited uniformly and to a large extent in 2019 from falling interest rates and the continuing high demand for interest-bearing investments.

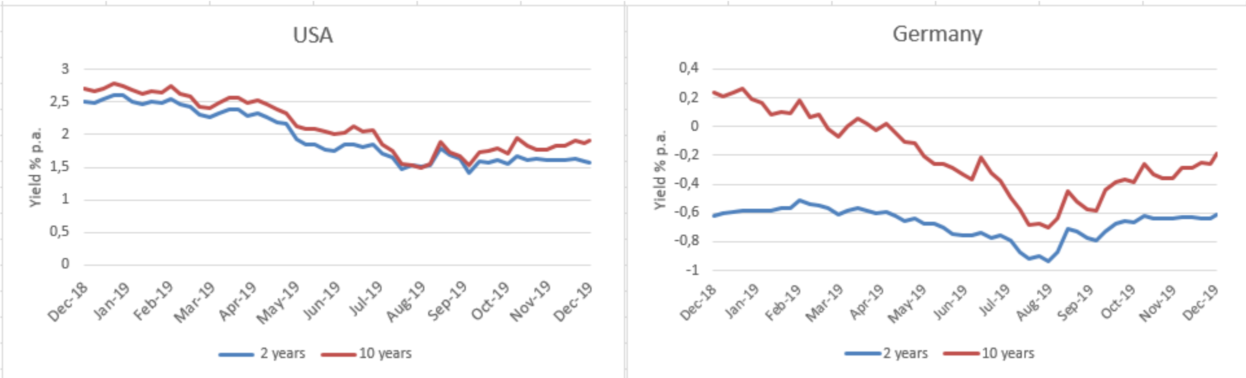
The US Federal Reserve executed a remarkable U-turn

In 2019, the change of course in monetary policy by the US central bank FED hovered over the financial markets. The FED left the previous rate hike course in an erratic swing and switched almost seamlessly into an aggressive mode with three key rate cuts and a new bond purchase program. This surprising change was triggered by serious fears of a recession, fueled by weak inflation and economic data and negative expectations due to the escalating trade conflict. Surely it is not completely wrong to attribute a large part of the positive market developments of the past year solely to the return of the FED to a policy of "cheap money".

The European Central Bank (ECB) as well as the Japanese central bank (BoJ), both of which, in contrast to the FED, had not yet made a real exit from ultra-loose monetary policy, were forced to act by the FED´s action and in turn made decisions that had new expansionary effects on the monetary base.

As expected, the activities of the central banks triggered a drop in interest rates and a flattening of the yield curves. The difference in yield between short-term and long-term bonds narrowed even further. For the euro zone, the risk-free interest rate (by definition for debt instruments of the Federal Republic of Germany), regardless of whether it was for maturities of 3 months or 30 years, was completely negative for the first time in August 2019.

Yield development of 2- and 10-year government bonds USA and Germany



Data source: Bloomberg

The fact that investors were apparently willing to accept a “custody fee” in the form of negative returns for the safe storage of their euros is, in addition to known regulatory causes, primarily due to the continuing large number of political uncertainty factors.

Politics more of a disruptive factor in 2019

In the past year, too, the financial markets were often affected by numerous political events. Many of the relevant topics have been following us for a long time and are known accordingly.

We therefore want to concentrate on what we see as the two most important developments:

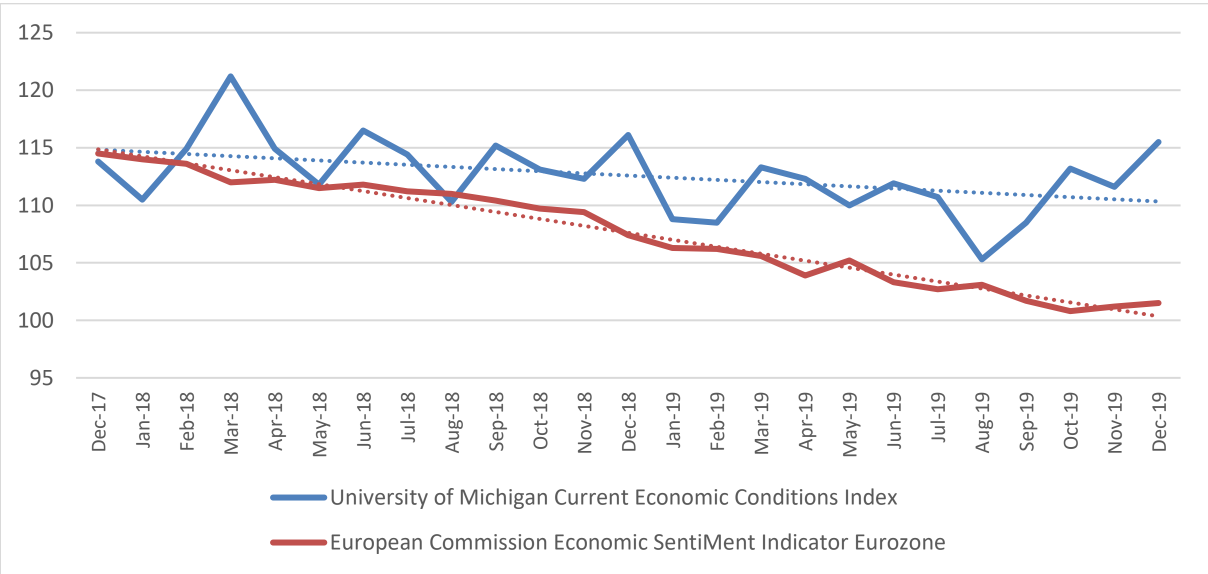
- The US-China trade conflict caused alternating emotions on the financial markets almost all year round. Despite the lack of progress in negotiations, the American side repeatedly managed to generate short-term optimism through hasty reports of success, which was then disappointed again a short time later by counterproductive actions. It was only in December, shortly before the entry into force of new special tariffs, that a "cease fire" was announced and a preliminary contract was announced for January 15, 2020. The escalation spiral came to a standstill for the time being.

- After countless votes in Parliament, the failure of the May government, new elections and another vote under the new majority, the deadlocked struggle to leave the EU was ended in Great Britain. The “BREXIT” is now scheduled for January 31, 2020, with a one year transition period. Until then, the exit agreement has to be negotiated with the EU, which somewhat reduces the likelihood of a “hard BREXIT”, but does not rule it out given the tight time frame for the negotiations.

Economic sentiment deteriorated, but so far there has been no recession

Measured by fears that a global recession was almost certain to come at the beginning of 2019, the real economic development in most countries was positive last year. The growth rates (preliminary data) of the gross domestic product (GDP) for the large developed economies ranged between + 0.5% (Germany) and + 2.3% (USA). China's GDP development of + 6.2% was slowed from the trade conflict and the weakness of the Chinese currency. In particular, private consumption, supported by high levels of employment, wage growth and tight labor markets, has promoted economic growth in almost all countries. The economy in export-dependent countries (e.g. Germany) came under greater pressure from the trade conflict with the USA.

Development of the economic sentiment in the US (blue) an the Eurozone (red)



Data source: Bloomberg

We find it remarkable that the sentiment indicators are drifting apart starting in August 2019. This starts precisely with the interest rate cuts by the US Federal Reserve (FED) - the first in over 10 years.

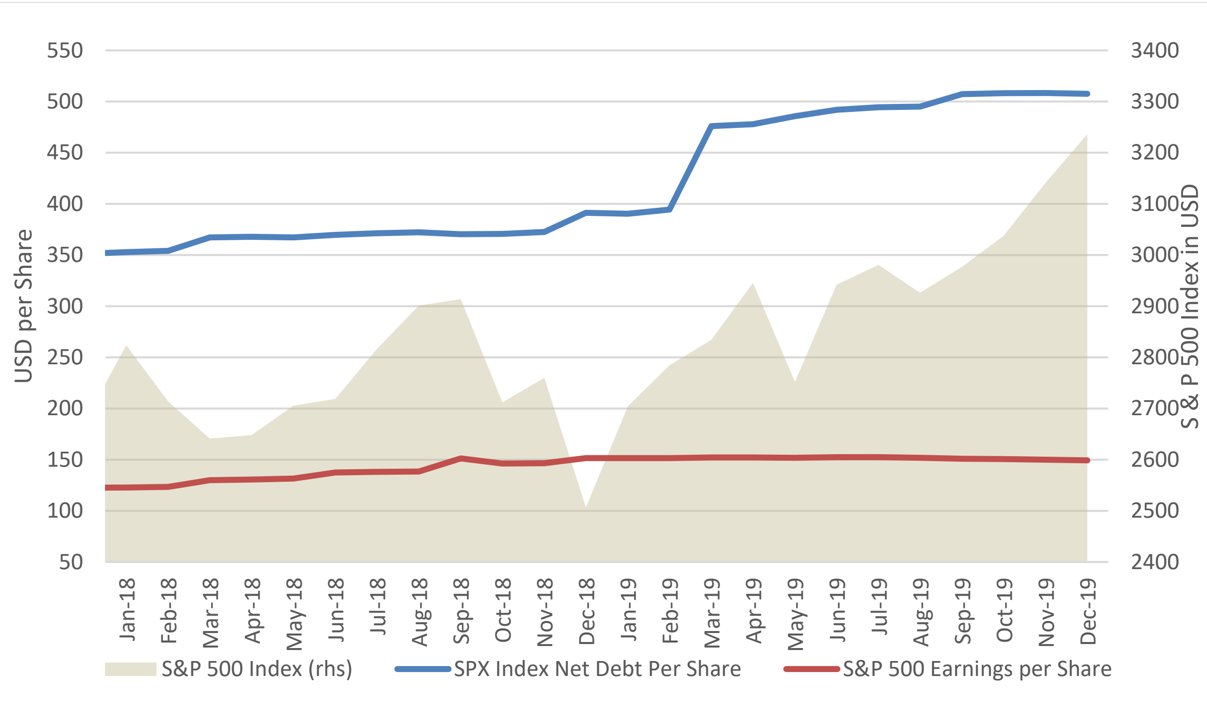
Equity markets with strong rise despite stagnating corporate results

In addition to the “positive background noise” for the stock markets that has existed for many years - the expansion of the monetary base due to the expansionary policy of the central banks – another development deserves closer examination, which, also caused by the record low interest rates, led to further rising stock prices: the significant increase in corporate debt.

The development in the past two years is already revealing. From the end of 2017 to 2019, the net debt (liabilities less cash) of the companies included in the S&P 500 rose by around 44%.

In the past year alone, the increase was almost 30%. In view of the very low cost of debt, a higher level of debt makes economically sense if the higher level of debt actually leads to additional investments in the company and not, like so often, to the buyback of the company's own shares. These share buybacks tend to lead to rising share prices. The reduced number of shares outstanding ensures that the profit generated is distributed over a smaller number of shares. Earnings per share can therefore increase, even if the actual operating profits remain the same or even decrease slightly! As a result, it becomes more difficult to compare the real earnings situation of the companies with previous years.

Development of the US stock market and development of profit and net debt of the companies contained in the index (example S&P 500)



Data source: Bloomberg

In the past two years there has been an increase in profits in the S&P 500 companies of approx. 22% versus a 21% increase in share prices. In 2019, profits remained practically unchanged, while stock prices rose by approx. 30%. The significant increase in share prices in the last quarter of 2019 should be understood as an anticipation of the recently strongly increased earnings estimates for the next two to three years. The current consensus estimate for the S&P 500 anticipates an increase in corporate profits for 2020 of 14.4% and a further 15% by the end of 2022. These estimates appear to us to be quite optimistic in view of the expected political and economic influences. The liquidity created by the central banks forms a not inconsiderable part of the basis for these profit estimates. The impression that the development of the stock markets has decoupled somewhat from the real economy is therefore inevitable.

We continue to monitor the development of the stock markets with a bit of skepticism and give preference to maintaining tactical liquidity over euphorically high investment rates at the start of the new year.

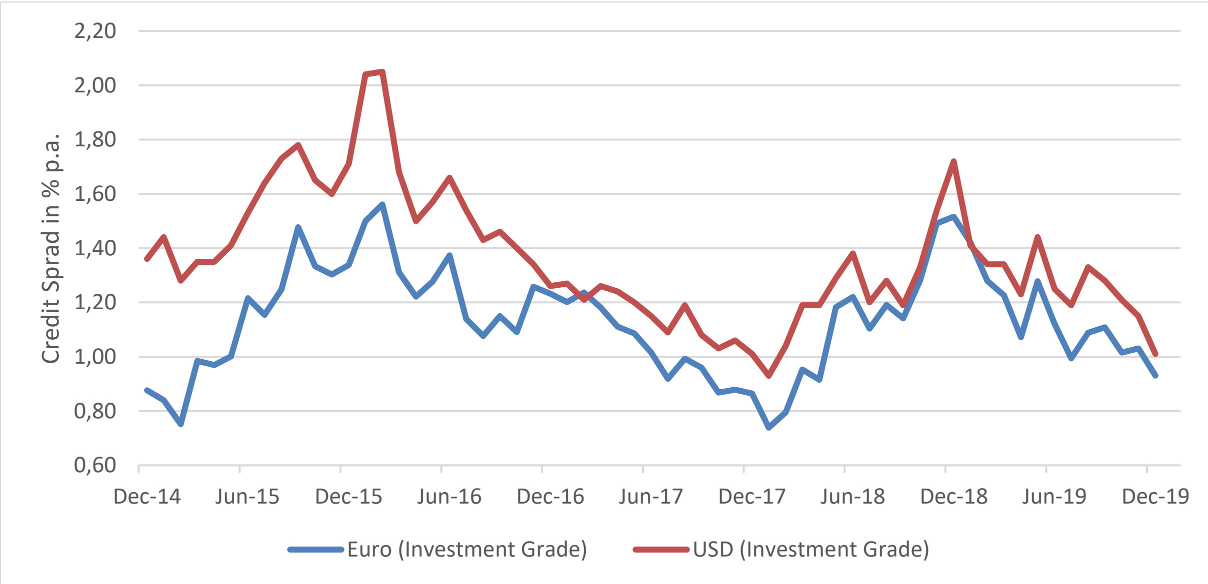
Corporate Bonds – Yield with positive prefix is tempting

Corporate bonds, unlike stocks (equity, return depending on company success = dividends) represent corporate debt (liabilities, return independent of company success = interest). In addition to the solvency of a debtor, the risk premium (credit spread) for the potential default risk paid with the higher interest rate is particularly important.

The risk premium depends on the expected future solvency of the debtor. With rising interest rates (= financing costs) and an unfavorable environment (falling sales, rising costs, possibly losses of the company) there are more and more payment defaults.

The persistent "hunt for yield" due to the abundant liquidity has recently brought risk premiums back to a lower level after the brief outbreak in 2018.

Development of credit spreads for US-Dollar- and Euro-Corporate Bonds



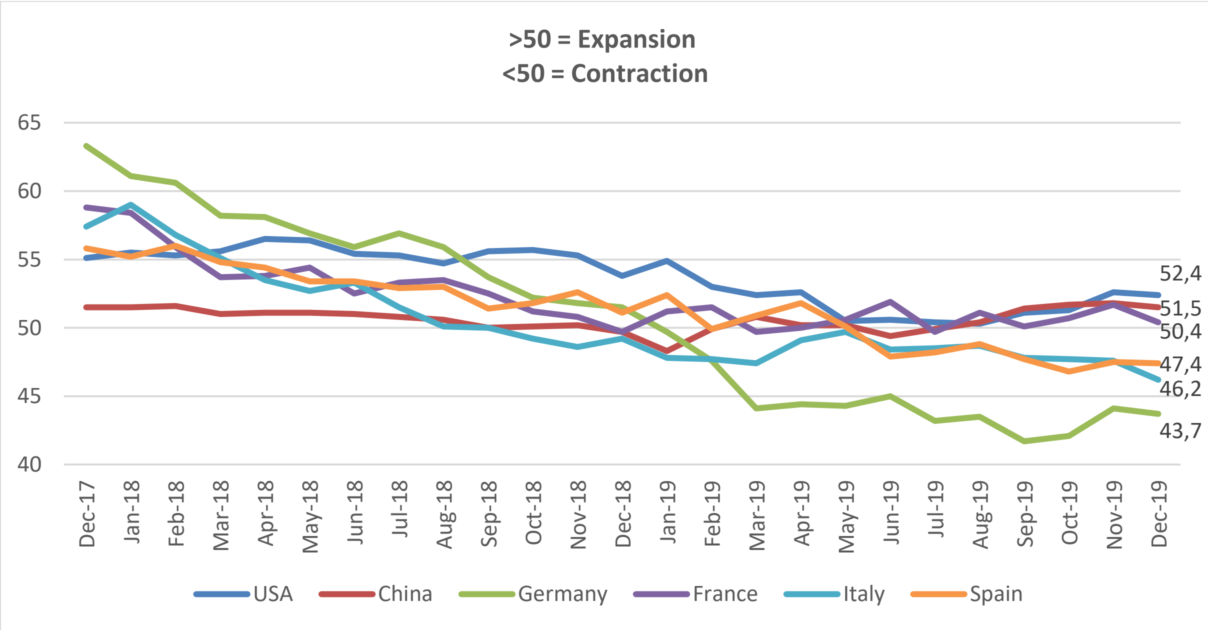
Data source: Bloomberg

The increasing indebtedness of governments, private households and companies, but also the continuing funding deficits in many public budgets worldwide, are causing the "credit bubble" that is building up further. This is a risk that we continue to be concerned about. We pay particular attention to the changes in the credit ratings of the debtors. For some time now there has been an increase in the share of ratings in the lowest investment grade segment (BBB-), which would be the first to come under strong selling pressure if the favorable financing conditions start to “topple”. Under the current conditions, we still consider carefully selected investments in corporate bonds to be justifiable. We avoid government bonds due to the often negative yield and the lack of significant risk premiums.

No economic worries for the time being?

We assume that the central banks will continue to counteract such serious recession expectations like in 2018/2019 with all available means in the future, as experienced. In addition to the established monetary policy instruments, we can also imagine that central banks will use strategies that have not yet been tried and tested. We also see an increasing trend towards fiscal stimulus, i.e. increased investment by the government. In 2020, consumer behavior by private households will also be decisive for the economic development. In this respect, "harbingers" of changes such as spending behavior and labor market developments must be observed closely.

Leading economic indicator – purchasing manager indices (industry)



Data source: Bloomberg

The strong declines in the leading economic indicators ("purchasing manager indices" - see chart above) in 2019 are not likely to repeat themselves for the time being. The development of the last three months of 2019 indicates at least a preliminary stabilization.

What could endanger the continuation of the positive trend in the new investment year?

Numerous events with a potentially far-reaching impact on the financial markets are emerging for 2020. Here is a selection of the most important from our point of view:

- The US presidential campaign and the November election. Here we see the danger that domestic problems and deficits will also be covered with foreign policy adventures. Even the yet incomplete process of nominating a Democratic presidential candidate can lead to uncertainty if a candidate from the left-wing political spectrum would get more impetus in surveys.

- International trade relations continue to deteriorate. The example of the American sanction plans against the companies involved in the Russian-German gas pipeline "Nord Stream 2" shows that the inhibition threshold in asserting national self-interest continues to decrease. Even a change of government after the US presidential election is only likely to defuse this issue to a limited extent, since the sanctions are approved by both parties in the USA. The yet long negotiation path in the US-China trade conflict and all other aspects of the American attempt to hinder the rise of emerging powers such as China or Russia will further on produce interference signals for the investment markets.
- Middle East escalation. A to be expected strong rise in oil prices would trigger inflation expectations which currently completely lack. Recession fears, such as at the end of 2018, would result. The investment markets would be surprised in a phase of stressed-high valuations. Rising financing costs (interest and risk premiums) combined with extremely high levels of debt would have to be combated through massive monetary and fiscal measures.
- The BREXIT will remain an ongoing topic in 2020. The exit agreement to be negotiated and concluded in a short time and a more self-confident conduct of negotiations by the British side due to the latest election results still make a hard BREXIT with considerable disruptions to intra-European trade or the international supply chains possible.

Regardless of the pervasive risks, the very expansive central banks worldwide with their abundant supply of liquidity to the capital markets and the economy and hence the resulting low interest rates provide a theoretical justification for the high valuation levels, low default rates for loans and the ability to continuously service the accumulated debt mountain.

In economic terms, it seems to us that the upturn in the historically long cycle can continue for some time thanks to robust private consumption and a stabilization of international trade.

A continuation of the positive trend, albeit with the clear expectation of volatility, is therefore our main scenario for the year 2020.

Where do we want to invest in 2020?

We do not expect any significant change in today's market conditions for 2020. The interest rate level will remain extremely low worldwide for structural reasons (level of debt) and monetary policy reasons (interest rate increases appear only possible with a strongly negative impact on asset prices). However, additional scope for interest rate cuts in currency regions with already existing negative yields such as the euro zone, Switzerland or Japan and the ultimate investment alternative "cash" or "gold" is likely to be extremely limited. An important driver for rising bond prices will therefore disappear in 2020.

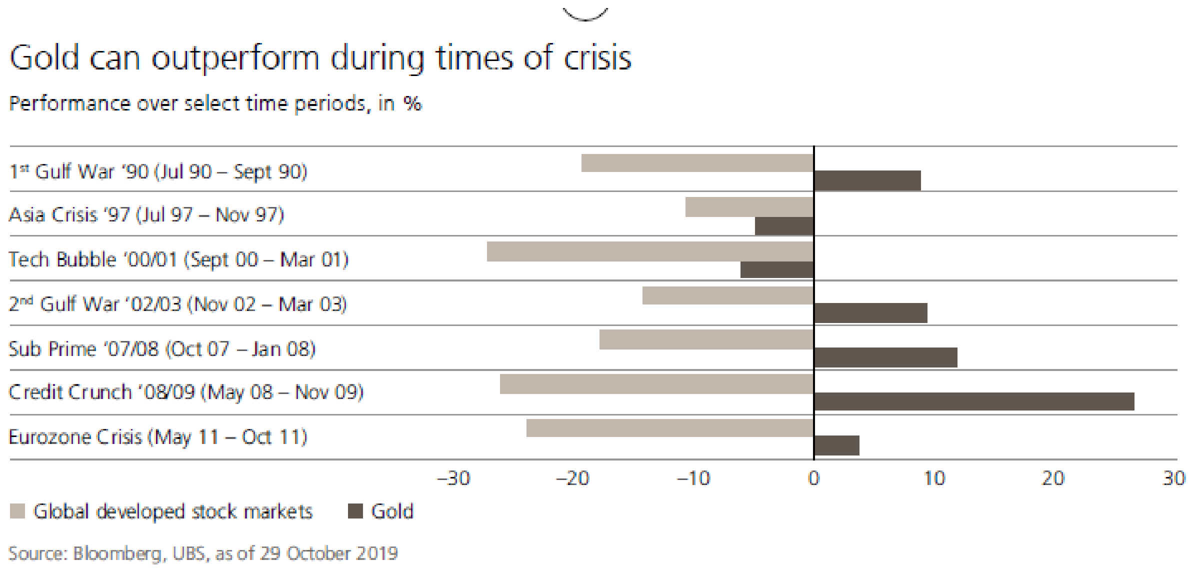
Risk premiums (e.g. for corporate bonds) may decrease further due to demand and persistent liquidity pressure will continue to drive the price development of assets such as shares or real estate, regardless of the increased volatility.

As stated above, we are skeptical of equities from a fundamental valuation point of view. A possible, albeit clearly opportunistic, reason to change this view would be, for example, the appearance of new buyers on the stock market: the FED or, due to the more limited options for action, the ECB. In any case, this would not be a real surprise. Both the Bank of Japan and the Swiss National Bank have been buying stocks and equity index funds on a large scale for years.

For the near future, there is some evidence that the positive development will continue. Regardless of this, corporate, state and private indebtedness continues to grow and reduces resistance to economic shocks. The imbalances are getting bigger. We are already thinking about the long-term consequences of this development today. We firmly assume that we will have to react to this later.

In 2020, BPM's asset management mandates will focus on the following investment topics:

- Multi-asset strategies with demonstrably successful risk management, a broadly diversified portfolio and correlated as little as possible with "classic" investment forms.
- Highly flexible investment strategies based on certain abilities of the investment manager (so called "Liquid Alternatives")
- Strategies that can benefit from market fluctuations (volatility) and generate income from them
- Gold remains the most important stabilizer in the portfolios we manage,
    - on the one hand because of its quality as "debt-free money" and a safeguard of value in times of crisis,
    - on the other hand because of its risk-balancing characteristics (negative correlation) to risk investments, e.g. shares.



What you can expect from us

In 2020, too, we will manage the funds entrusted to us with discipline and prudence. Our broadly diversified and essentially countercyclical strategy is designed to ensure nothing less than the protection of your assets. Wherever it appears possible without substantial risks, we will use targeted return opportunities to achieve investment success.

Yours

BPM – Berlin Portfolio Management GmbH

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